2013 Hedge Fund Outlook
Some gains, more pain
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Introduction

They say what doesn’t break you makes you stronger. For hedge funds, 2012 was a backbreaking year to put it mildly. Heightened market volatility, stressed global macroeconomic conditions, and underperformance relative to traditional investing vehicles were just a few of the factors that challenged hedge funds in 2012. Add the extra weight of an increasing regulatory burden, and many fund leaders might have been forgiven for packing it in.

But something telling happened instead — the industry emerged from 2012 stronger than it went in, surpassing the records set in 2007 for assets under management (AuM) and absolute number of funds. Those that remained settled into a more measured and sustainable pace of growth, with money flowing mainly to hedge funds who altered their routines by adjusting to new demands from regulators and investors while looking for new ways to streamline back-office operations.

The coming year will be no less challenging. With the Securities and Exchange Commission (SEC) registration now behind them, hedge funds will be subject to ongoing Form PF reporting and, for the first time, risk-based examinations. We also expect there to be some additional clarity on other pending matters on the regulatory front. Additionally, institutional investors, whose hedge fund allocations have increased five-fold since 2003, will continue to exert pressure on companies for greater transparency and customized fee arrangements, more closely aligning manager and investor interests.

Despite these ongoing challenges, we believe the industry is positioned to grow opportunistically in 2013. Institutional investors’ appetite for alternatives continues to increase as bond yields hover near all-time lows, public pension underfunding approaches record levels, and equity market volatility upends more traditional investments. The average institutional allocation in hedge funds is about 10 percent and is expected to double by 2016. Those numbers could in fact be low if hedge funds return to historic performance levels; just 43 percent of hedge funds had reached their high-water marks by the end of September.

Make no mistake: The coming year will be an important one for performance if firms hope to return to earning more than just management fees. We expect hedge funds to engage in the following three strategies as they seek to close this performance gap and position themselves for increased allocations in 2013:

• Fostering a compliance culture
• Competing for new assets with targeted strategies
• Addressing fee pressure through operational streamlining

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1 As per HFR as of 2Q12.

Compliance has become a top priority for hedge fund executives given the increasing regulatory burden and push by investors for additional transparency. The implications of new rules stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Foreign Account Tax Compliance Act (FATCA), and the Alternative Investment Fund Managers Directive (AIFMD), are far from settled, but there is a general recognition among hedge fund leaders of the need to fortify their compliance policies, procedures, and personnel in order to stay agile and responsive in this dynamic regulatory environment. This awareness extends to the need to ensure that hedge funds maintain adequate oversight of service providers, who are taking on more responsibility in performing regulatory functions.

Back-office resources were severely tested in 2012 by two key compliance hurdles: SEC registration and Form PF. According to a Hedge Fund Alert article, Bank of America estimates, some large hedge funds spent upwards of $500,000 just in completing a first-year Form PF.5

What’s new for 2013
With more than 1,500 new private fund advisers registered with the SEC in late 2012, hedge funds will open their doors in 2013 to the new SEC inspection regime.6 In advance of these risk-based “presence exams,” the SEC has told fund advisers that it will be focused on five key compliance areas: marketing, portfolio management, conflicts of interest, the safety of client assets, and valuation.7

Some in the industry have expressed concern about the agency’s level of sophistication when it comes to hedge funds, but we believe regulators have strengthened their hand by enhancing their capabilities in some important ways. For example, SEC examiners are increasingly incorporating data analytics to identify aberrational trading or performance and detect instances of insider trading.

We believe 2013 will also bring increased clarity on several other compliance-related topics among hedge funds, including FATCA, Commodities Futures Trading Commission (CFTC) registration, AIFMD, and tax legislation reform.

In addition to stepped-up pressure from regulators, we also expect institutional investors to expand their demands for greater transparency into new areas such as cyber security and fraud prevention programs.

Bottom line
Given the reputational harm that can come from an enforcement case, compliance is now a critical component of a hedge fund’s culture, perhaps as important to their survival as investment performance.

The problem is that many pending regulatory matters remain unresolved. Dodd-Frank is a prime example, with roughly two-thirds of its rules not yet finalized.8 In addition, the role certain regulatory bodies will eventually play has yet to be determined. And then there is the arrival of Elisse Walter at the helm of the SEC, and the question of how dramatically the agency’s priorities may change as a result.

One thing is for certain: Pressure from regulators won’t abate anytime soon. This year will bring increased emphasis on managing the compliance burden in a manner that integrates governance, controls, supervision, operations, and technology. A dedicated chief compliance officer is recommended for firms that have registered or plan to register with the SEC in 2013. A chief financial officer or chief operations officer might have been able to handle the added responsibilities before, but those days are clearly over.

Despite the increased scrutiny from regulators, the industry’s AuM broke through the $2 trillion barrier and may be poised to rise even higher as institutional investors shift more of their investments toward risk-driven classifications and expand the pie of their alternative asset allocations.

Still, we recognize the near-term growth outlook is not that rosy. The industry’s relative underperformance during the last few years has some investors questioning the value add of hedge funds and they are exerting downward pressure on fees as a result. “Two-and-twenty” is no longer sacred, and fee flexibility is becoming the new normal.

For certain, some hedge funds will inevitably generate outsized returns in 2013 and offset these kinds of pressures, but the search for alpha will likely remain elusive for most. As such, we do not expect the industry to snap out of its lull overnight.

Nevertheless, we do believe certain hedge funds are positioned to grow opportunistically in 2013, particularly those that offer investment strategies emanating from emerging global trends.

With the hedge fund industry maturing, competition is intensifying from traditional and non-traditional asset managers in the industry. New entrants are accelerating industry convergence by blurring the lines in some cases between hedge funds, private equity funds, and mutual funds. Hedge funds are also playing a part in this evolution, with some funds pursuing new investment strategies and distribution channels involving private equity, mutual funds, and other domestic or foreign registered products such as UCITS.

We expect these diversification strategies to continue in 2013, with some firms also expanding geographically, into emerging or even frontier markets, or into new asset classes such as European credit. Alpha opportunities may also be found in certain asset classes like real estate or distressed debt.

For those hedge funds that are not interested in expanding into a diverse mix of strategies, we see other opportunities in 2013. For instance, we believe certain emerging managers will revert to the industry’s entrepreneurial roots by generating alpha through niche strategies such as structured credit, frontier market debt, or other illiquid fixed income instruments.

If 2013 turns out to be as challenging as the previous few years, expect more interest around the topic of succession. If the past is any indication of the future, then we may see more large, well established hedge fund founders pass the baton on to the next generation of managers, leaving a younger, less road weary group to deal with demanding investors and regulators.

Bottom line

Large hedge funds are in some cases better positioned for growth in 2013 by being able to leverage broad-based competitive advantages across investments, distribution, and operations. However, in an industry where performance ultimately drives success, scalable smaller managers and niche hedge fund strategists should have plenty of opportunities in the year ahead.
Addressing fee pressure through operational streamlining

The combination of limited top-line growth and operational cost creep has put many hedge funds in the prickly position of grappling for productivity gains. Compliance costs are rising, institutional investors are increasingly seeking customized service levels, and alpha generation has grown more challenging. We see 2013 as a year in which hedge funds consolidate these efficiency gains while digging deeper into their organizations looking for more cost-cutting opportunities.

What’s new for 2013
We believe hedge funds will increasingly turn to outsourcing, process efficiencies, enhanced data management, and technology solutions to help alleviate these operational strains in 2013. These strategies will be particularly important to those hedge funds that patched together temporary fixes to deal with new compliance burdens in 2012, while postponing the implementation of long-term solutions.

Outsourced service providers will likely play a growing role in support of data-intensive regulatory-driven initiatives (e.g., Form PF reporting) and compliance programs. Middle-office functions such as trade processing or corporate actions processing, or even certain activities like collateral management that are closer to the front office, could also be prime outsourcing candidates. While retaining oversight responsibilities in-house, hedge funds will turn to new outsourcing models that transfer resource-intensive operational, regulatory, and technology activities to external partners with scale advantages. This approach will help comfort those who fear losing control through outsourcing relationships while alleviating significant cost pressures and increasing fee transparency with fund investors.

The industry’s views on technology will also continue to evolve, as more chief information officers embrace creative ways to reduce costs and risks by better integrating service provider connectivity, enhancing risk analytics, leveraging data management, and offloading certain commoditized trading activities, among other opportunities. Hedge funds both small and large are increasingly scrutinizing the escalating costs of market data. Larger hedge funds with internal operational infrastructures will arguably benefit more from this technology rethink, but smaller funds will be able to generate technology-driven efficiencies either directly or through service provider relationships. Hedge funds lacking a streamlined data warehouse may adopt specialized bolt-on systems to help them address the inflexibility of legacy technologies in dealing with increasing demands from regulators and investors. Others will migrate to cloud-based software solutions, given the increased sophistication and security protections they offer for front- and back-office functions.

Bottom line
The increasing regulatory burden, combined with investor pressure to provide greater transparency and reduce fees, amounts to a new operating reality for hedge funds. It may be difficult for all but the largest funds to justify the investments needed to sustain an institutional-grade operation while confronting increasing operational demands. Ongoing industry consolidation is one ramification of this difficulty. But we believe that some may be able to alleviate this pressure and level the playing field by turning to partnership strategies that incorporate a blend of outsourcing and technology.
The hedge fund industry faces no shortage of challenges, but we see its current struggles as a form of resistance training. Hedge funds are being forced to invest in their infrastructure to shoulder the growing strain of regulatory and investor demands. When those demands lessen, hedge funds will emerge as stronger and more structurally capable of winning investors’ confidence.

In the meantime, the industry will have to do what it can to manage the added burden while delivering alpha. We see cause for optimism in this respect. Leading head funds are getting ahead of regulatory uncertainty by fortifying their compliance policies, procedures, and personnel. Others are adjusting to downward pressure on revenue by instituting new fee structures and exploring new distribution channels. And many more are tapping process efficiencies and technology solutions to streamline their operations.

We have every confidence that these changes — and more to come — will position the industry to effectively manage this increasingly dynamic and challenging environment in the year ahead.

The question now is whether hedge funds can find alpha with the extra weight of increasing investor and regulator demands.
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